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No. 503

In the Supreme Court of the United States

OCTOBER TERM, 1941

PALM SPRINGS HOLDING COPORATION, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The memorandum opinion of the United States Board of Tax Appeals (R. 22–35) is unreported. The opinion of the Circuit Court of Appeals (R. 88–95) is reported in 119 F. (2d) 846.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered May 14, 1941. (R. 96.) The petition for a writ of certiorari was filed August 11, 1941,

and was granted on October 13, 1941. The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by Act of February 13, 1925.

QUESTION PRESENTED

Pursuant to plan, a bondholders protective committee formed the taxpayer, a new corporation, which acquired the assenting bonds and issued in return therefor, and for certain other considerations, its preferred and common stock. Thereupon the taxpayer purchased the mortgaged assets from the indenture trustee, paying the bid price in part by a surrender of the bonds.

The taxpayer subsequently purchased at foreclosure sale certain personal property which had been mortgaged to the debtor corporation by a third company as security for a lease; this lease and chattel mortgage had been pledged as additional security for the debtor's bonds and had been included in the property bought from the indenture trustee.

The question is whether the basis of the assets, for purposes of computing depreciation, is the same as it would be in the hands of the debtor corporation and the third company under Section 113 (a) (7) of the Revenue Act of 1932.[1] The answer

[1] This Section, made applicable by Section 113 (a) (12), of the Revenue Act of 1934, is the same as Section 113 (a) (7) of that Act.

depends upon whether the transactions constituted reorganizations within the definition of Section 112 (i) (1) of the Revenue Act of 1932.

STATUTES INVOLVED

The statutes involved are set forth in the Appendix, *infra*, pp. 12–15.

STATEMENT

The Palm Springs Hotel Co., the taxpayer's predecessor corporation, owned the El Mirador Hotel at Palm Springs, California. This company (hereafter referred to as the Hotel Company) had outstanding in 1932 an issue of approximately $300,000 face amount of first mortgage bonds, secured by a lien on its real property; as of September 1, 1931, its outstanding stock consisted of 3,213 shares of preferred and 110 shares of common. (R. 23.)

The Hotel Company also owned 738 shares of a total of 1,253 shares outstanding of the Palm Springs Hotel Operating Co, (hereafter referred to as the Operating Company).[2] This company operated the hotel under a lease from the Hotel Company. It also owned the furniture and fixtures in the hotel, which it mortgaged to the Hotel Company as security for performance of the terms of

[2] The Palm Springs Hotel Operating Co. subsequently changed its name to El Mirador Hotel Operating Company. (R. 23.)

the lease. The lease and chattel mortgage were assigned and pledged by the Hotel Company as part of the security for the bond issue. (R. 23–24.)

In the spring of 1931, both companies were in financial difficulties and unable to meet their respective obligations. Each levied an assessment of $20 per share on its capital stock. (R. 24–25.)

On August 20, 1931, a bondholders committee was formed, and bonds of a face value of $167,500 were deposited with the committee under the terms of the deposit agreement. (R. 25.)

The next month both companies sold for nonpayment of the assessment, and themselves bought in, all of their shares of stock with the exception of certain shares owned by Warren B. Pinney, president of the two companies. Pinney paid the assessments on five shares each of the common and preferred stock of the Hotel Company and on ten shares of the stock of the Operating Company. Thereafter, he was the sole stockholder of each of the two companies. (R. 24–25.)

The Palm Springs Holding Corporation, the taxpayer, was incorporated under the laws of California on April 1, 1932. Its authorized capital stock consisted of 3,000 shares of 6% noncumulative preferred stock of a par value of $100 each and 7,500 shares of common stock without par value. (R. 25–26.)

In accordance with a plan of reorganization, set forth in a letter from the bondholders com-

mittee, six shares of the taxpayer's preferred stock and four shares of the common were issued to assenting bondholders for each $1,000 bond. (R. 26.) In addition, all of the taxpayer's common stock, not required to be issued in exchange for bonds, was issued to R. D. Lacoe in return for his agreement to pay the costs of incorporating the taxpayer up to $1,000 and for his agreement to lend money to the taxpayer, as set forth in the plan of reorganization. (R. 27.) Since Lacoe was also a holder of $119,000 of bonds of the Hotel Company, he likewise received a distribution of six shares of preferred stock and four shares of common stock for each $1,000 face amount of his bonds. (R. 26–27.)

The aggregate disfribution of the taxpayer's securities, in accordance with the plan outlined, was as follows (R. 26):

	Face Value Bonds Exchanged.	Stock of Taxpayer Issued.	
		Preferred Shares.	Common Shares.
Bondholders	$173,000	1,038	692
R. D. Lacoe	119,000	714	476
R. D. Lacoe	none	----------	6,332
	$292,000	1,752	7,500

Before the actual issuance of any of these shares, Lacoe transferred 1,000 shares of the common stock to Pinney, then the sole remaining stockholder of the two companies, for his services in the reorganization and as an inducement to con-

time as manager of the hotel. (R. 29.) None of the stock of the taxpayer, however, was issued to any stockholder or former stockholder of the Hotel Company or the Operating Company for any rights any of them might have had as stockholders of the companies. (R. 29–30.)

On or about May 21, 1932, the indenture trustee declared the principal of the bonds due and payable. On July 15, 1932, the trustee sold all of the properties of the Hotel Company to the highest bidder pursuant to the terms of the indenture. The taxpayer was the successful bidder and acquired all the properties of the old corporation, including the lease and chattel mortgage for a bid price of $61,800. This price was satisfied by the payment of $18,787.96 cash, and by the delivery to the trustee of bonds of a face value of $292,000 for the balance. (R. 27.)

The properties were conveyed to the taxpayer on July 15, 1932. Thereafter, the taxpayer instituted foreclosure proceedings against the Hotel Company and the Operating Company; obtained a judgment of $77,918.79 against the Operating Company; and on August 2, 1932, bought in the fixtures and furniture, comprising all the properties of the Operating Company, at foreclosure sale for a bid price of $20,179.25. (R. 28.)

The total amount of bonds of the old corporation outstanding in July 1932 was $309,000. (R. 23.) The cost of the buildings to the old cor-

poration, including all additions up to 1932, was $686,731.97. The cost of the furniture and fixtures to the Operating Company, acquired by the taxpayer on August 2, 1932, including all additions up to that date, was $232,544.10. Additions made by the taxpayer up to May 31, 1936, cost it $82,652.81 with respect to the real estate and $40,485.18 with respect to the personalty, making the aggregate figures $769,384.78 and $273,029.28. (R. 29.)

The Commissioner, in determining a deficiency in the taxpayer's income and excess profits tax for the fiscal year ended May 31, 1936, disallowed depreciation deductions on both the real estate and the personal property, which had been taken on a basis of the foregoing figures. The Commissioner, rejecting the contention that these assets had been acquired in a non-taxable reorganization, used as the basis the cost of the assets to the taxpayer, measured by their value upon acquisition plus the cost of additions. (R. 13–15.) The Commissioner's basis was $370,955.32 for the real estate and $138,108.67 for the personalty.

The Board of Tax Appeals sustained the Commissioner's determination with respect to the personal property but rejected it with respect to the realty. Upon cross-petitions for review, the Circuit Court of Appeals sustained the Commissioner on both points.

ARGUMENT

A.

This case presents the same fundamental problem as that before the Court in its companion proceedings: *Commissioner* v. *Southwest Consol. Corp.*, 119 F. (2d) 561 (C. C. A. 5th), certiorari granted October 13, 1941, No. 286, this Term; *Commissioner* v. *Alabama Asphaltic Limestone Co.*, 119 F. (2d) 819 (C. C. A. 5th), certiorari granted October 13, 1941, No. 328, this Term; and *Commissioner* v. *Bondholders Committee, Marlborough Investment Co.*, 118 F. (2d) 511 (C. C. A. 9th), certiorari granted October 13, 1941, Nos. 128 and 129, this Term. The Government's position has been fully developed in its brief in the *Southwest Consolidated* case, to which the Court is respectfully referred.

B.

As in our *Alabama Asphaltic* and *Bondholders Committee* briefs, however, we wish to direct the Court's attention to those points of difference which exist in this case:

(1) In all of the other cases, the assets in question were bought in by the committee and then transferred to the new corporation in return for a distribution of its securities in accordance with the plan proposed. Here, the reverse procedure was employed. The new corporation was formed first; the deposited and assenting bonds were

transferred to it; the new corporation's securities were issued as the plan contemplated; and thereafter, the new corporation acquired the mortgaged assets directly at the trustee's and foreclosure sales.

The transaction thus fits the literal language of clause A of the statutory definition of a reorganization—i. e., "the acquisition by one corporation of * * * substantially all the properties of another corporation." Revenue Act of 1932, Section 112 (i) (1) (a).[3] But as we pointed out in our *Alabama Asphaltic* brief (p. 7), the conclusion would not alter the ultimate result. The controlling fact is that irrespective of the literal language of the statute, the absence of a continuity in the new corporation of the proprietary interest in the old takes the case beyond its purview. *LeTulle* v. *Scofield*, 308 U. S. 415. As the Board expressly found, none of the securities of the new

[3] The taxpayer also argues that clause B is applicable. However, even if we assume that the transfer was made by the old corporation, rather than by the indenture trustee or the sheriff at the judicial sale [but cf. *United States* v. *Galveston-Houston Electric Co.*, 84 F. (2d) 516 (C. C. A. 1st), certiorari denied, 299 U. S. 590], neither the old corporation nor its stockholders were thereafter in control of the new company within the requirement of clause B and the definition of Section 112 (j). In fact, "control" within the statutory definition was not even in the participating creditors since the majority of the new common stock had been distributed, for a consideration other than an exchange of bonds, to R. D. Lacoe and W. B. Pinney. For the same reasons, Section 112 (b) (5) would not be applicable.

corporation was issued in return for the former stock interests. The proprietary interest in the old corporation was shifted from its stockholders to its creditors. By the same token, immediately after the transfer, neither an interest nor control of the property of 50% or more was retained in the prior owners, as specifically required by Section 113 (a) (7) of the Revenue Act of 1932.

(2) The situation with respect to the personal property is unique in that it involves property which did not belong to the corporate mortgagor and which was not itself pledged under the bondholders' mortgage. The personalty was owned by the Operating Company. It was mortgaged as security for the leasehold obligation running to the Hotel Company, and both obligations were pledged to the bondholders. But the bondholders had no direct rights or interests either in the Operating Company itself or in its assets. They were creditors of a corporation holding, as part security for their debts, claims which the corporation had against a third company.

Consequently, the Board of Tax Appeals, even while holding that the bondholders were "stepped up" to the position of stockholders of the Hotel Company under the theory of *Commissioner* v. *Kitselman*, 89 F. (2d) 458 (C. C. A. 7th), certiorari denied, 302 U. S. 709, concluded that the metamorphosis ceased at that point. The Board held that the bondholders did not become "stock-

holders" of the Operating Company and could not be considered as owners of the physical assets of that company. The Board recognized that when the taxpayer took over the assets of the Hotel Company, it became the corporate owner of the lease and chattel mortgage. Its subsequent foreclosure was no different from that of any other foreclosure by a secured corporate creditor—a proceeding which clearly is not a "reorganization".

C.

The Commissioner in this case employed a valuation to measure the cost of the assets to the taxpayer and not the bid price at the foreclosure sale. The correctness of the valuation has not been challenged. If the Government is sustained, therefore, further proceedings for a determination of the taxpayer's cost in this case will not be called for.

Respectfully submitted,

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JANUARY, 1942.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * * *

(5) *Transfer to corporation controlled by Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. * * *. (U. S. C., Title 26, Sec. 112.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(8) *Property acquired by issuance of stock or as paid-in surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

* * * * *

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * *

(12) *Basis established by Revenue Act of 1932.*—If the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis thereof, for the purposes of the Revenue Act of 1932 was prescribed by section 113 (a) (6), (7), or (9) of such Act, then for the purposes of this Act the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

* * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided. * * *. (U. S. C., Title 26, Sec. 113.)

* * * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of

any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property. * * *.

(U. S. C., Title 26, Sec. 114.)

Section 112 (j) is identical with Section 112 (j) of the Revenue Act of 1932, *infra*.

Revenue Act of 1932, c. 209, 47 Stat. 169.

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(i) *Definition of reorganization.*—As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred. * * *.

(j) *Definition of control.*—As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(7) *Transfers to corporation where control of property remains in same persons.*—If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

The relevant provisions of Regulations 86 under the Revenue Act of 1934 are set forth in the Appendix to our brief in the *Southwest Consolidated* case. Regulations 77 under the Revenue Act of 1932 do not contain provisions material to the question in issue.

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